RICHARD RUSSELL'S **DOW THEORY LETTERS, INC.**

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October 20, 1982 **LETTER 846**

Oct. 8, DJIA 986.85; PTI 1323; A-D Ratio –22.68
Oct. 15, DJIA 993.10; PTI 1329; A-D Ratio –21.77

WHAT'S HAPPENING? For three years I have been insisting that because of its massive debts and deficits, this nation is in the position of having to "inflate or die." The fact is that you can't support the current $5.5 trillion in total US debt in an atmosphere of deflation. The Fed and the Reagan Administration have tried to deflate (pardon me, dis-inflate), and the result is something akin to an economic collapse. But now, the course has been changed.

Last week, as unemployment in the US rose to 10%, highest since the Great Depression, the story finally leaked out. The Fed has thrown in the sponge. No longer are the sacred perimeters of monetary growth to be respected. From here on, as far as the money supply is concerned, it's "let 'er rip." This clip (WSJ, October 9) says it all.

> **Credit Markets**
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> Investor euphoria was sparked by reports that the Federal Reserve System decided Tuesday to concentrate its efforts on healing the economy's deep wounds and to pay less attention to meeting its own money-supply targets in the weeks ahead. The Fed's willingness to allow the money supply to expand faster than originally planned relieved investor fear that the central bank would tighten credit conditions and push up interest rates.

And it boiled down to this: the economy is mired in recession, the 10.1% unemployment figure is an embarrassment to the Reagan Administration, the elections are coming up next month, Reaganomics is in tatters, and the Fed has elected to give a helping hand. That hand is better known as "opening the floodgates." To the public it's known as inflation.

The excuse (although nobody is asking for excuses) is that the economy is so rotten that no amount of pumping is going to turn the current mess into a boom. Anyway, that's the Fed's rationale. And if inflation does start up again, at least it won't get going until well after the November elections.

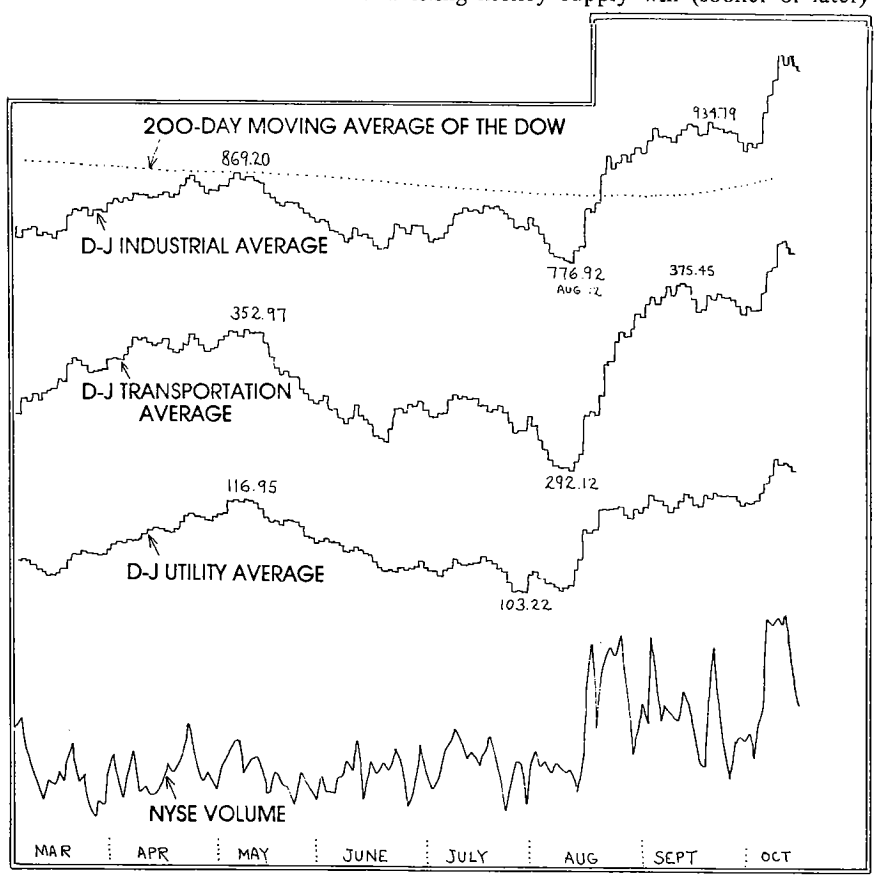
Meanwhile, the gold market is hardly buying this story. From its June 19 low of 297, gold rose to a September 6 actual London fix of 488.25. This represented a rise of 64% in a period of three months. Following this extraordinary rally, gold corrected back to exactly its 50-week moving average—touching 387.25 on October 5. From there gold has again surged well above the 400 mark. What does gold see? Gold sees the creation of vast new pools of new credits, gold sees the roaring money supply, gold sees that it's a case of "inflate or die" for the US, and gold knows that governments will do anything—to perpetuate themselves. That "anything" includes ballooning the money supply when business is slumping.

FRONT PAGE COMMENT: I'm still not sure exactly what we have on Wall Street, but one thing you can call it is—unprecedented . To my knowledge, there's never been a rise from a bear market low to (or above) the all-time highs without a single correction. But that's what we've seen since August. The structure is there for history to ponder.

"How high will it go?" I'm asked, and of course, no man alive can provide the answer to that one. But advances like this one usually run to exhaustion, and the 1982 explosion will be no exception. Straight-up moves, as this one, usually end in a spear-point top (we saw that in gold in 1980). Following the stock market rise, I would expect either (1) a severe correction, or (2) an extended decline which could wipe out one-half to two thirds of the rise.

Was it, or is it, a bull market? I can't tell yet. We'll know more about that when the inevitable correction materializes. But the PTI (see later section) is telling us that the secondary trend is up.

The stock market—what does it see? The stock market sees lower bond yields as a reason to move short-term money and bond money into stocks. The stock market hopes that lower interest rates and a rising money supply will (sooner or later)



spur business. The stock market believes that the worst was discounted in mid-August, and that business will be substantially better six months to a year from now. If we're in a bull market, then the stock market will nevertheless be subject to a correction. But if the bear still lives (even though he may be hibernating) then it's a matter of time before the current spike structure in the stock market comes sliding down to earth.

I operate on the principle that Wall Street and the stock market makes sense. I also operate on the principle that investing makes sense. The first rule in investing is that you don't lose your capital. If you lose your nest egg, then you're a captain without a ship, a carpenter without tools. Thus, retention of capital (safety) is my number one concern.

The second principle I operate on is return on my capital. If I can be sure of my capital's safety and I can also get a good return on that capital, then I have the best of two worlds.

The third cornerstone of intelligent investing is appreciation of capital. If I can expand my nest egg through appreciation that's great. But I know that capital appreciation is the hardest and riskiest of the three concepts. And it is the one I will give up first, all things being equal.

How to apply this thinking to the present? Occasionally, very occasionally the market does something extraordinary. And rarely, very rarely, the market does something new and ununprecedented. We saw some of that on August 12. On August 12 just about everything I follow, all my averages and indicators, broke to new bear market lows. When this happens, and it is followed by a rally, the odds are almost 100% that the Dow and many indicators will come down again to test the lows. Then if we get important divergence, if we get a SELECTIVE new decline with a number of non-confirmations, we have what would appear to be a good bottom, a bottom worth buying.

But the market has its own ways and its own reasons. In mid-August, as I see it, the market was angry at the bears, it was angry at the millions of shares that had been sold short. Finally, it was livid about the new easy way to make a killing–buying puts. So the market did what *the fewest number of people expected,* it went straight up and crucified the shorts–over a hundred million of them. And it drove the put buyers to the wall.

How did I miss the move? There is no way I could have caught it. No interpretation of the tools I use could have caught it. I've identified and predicted a lot of moves, but I'd be lying if I said that my data could have identified August 12 as a launching pad. The fact is that the explosion since August 12 was unprecedented.

Conclusion: We go back to the time-honored truism–the market can do anything! And August-October, 1982 proved it. Of course, what happened was that the whole market mechanism swung on interest rates, and the rates did tumble unexpectedly. Many veteran observers didn't believe, with this much DEBT overhanging the economy and with this much illiquidity in the nation, that rates could fall this fast and this far. But they did.

Question: Will the falling interest rates turn business around?

Answer: If they do, it's still going to take a while. In which case the stock market is going to have to deal with continuing pressure on earnings. But if the economy should turn up unexpectedly, then interest rates are going to start up again. It'a a vicious circle, and meantime, one thing is for SURE–the debts are continuing to build.

Question: Russell, there was a pullback towards the end of September in both Industrial and Transports. Then, on October 7, the Averages broke out again on the upside. Was that breakout a bull signal under Dow Theory?

Answer: Unfortunately, under strict Dow Theory we need a full correction of the initial rise, then an advance taking both Averages to new highs. The September pullback amounted to only 38 points in Industrials over a period of a mere seven days. That's hardly a correction. Therefore, under Dow Theory no bull signal was given.

Question: If no bull signal was given, then what do you call the rise from the August 12 lows?

Answer: It's one of the most spectacular upward explosions in stock market history. Frankly, there's never been anything like it. The rise started from fresh lows in all the indicators and averages, it began from only semi-oversold market conditions. The rise brought in immediate institutional and foreign buying (both of these groups tend to be wrong in the initial stages of any major move). So the question is–what do we do now?

Question: Right, what *do* we do?

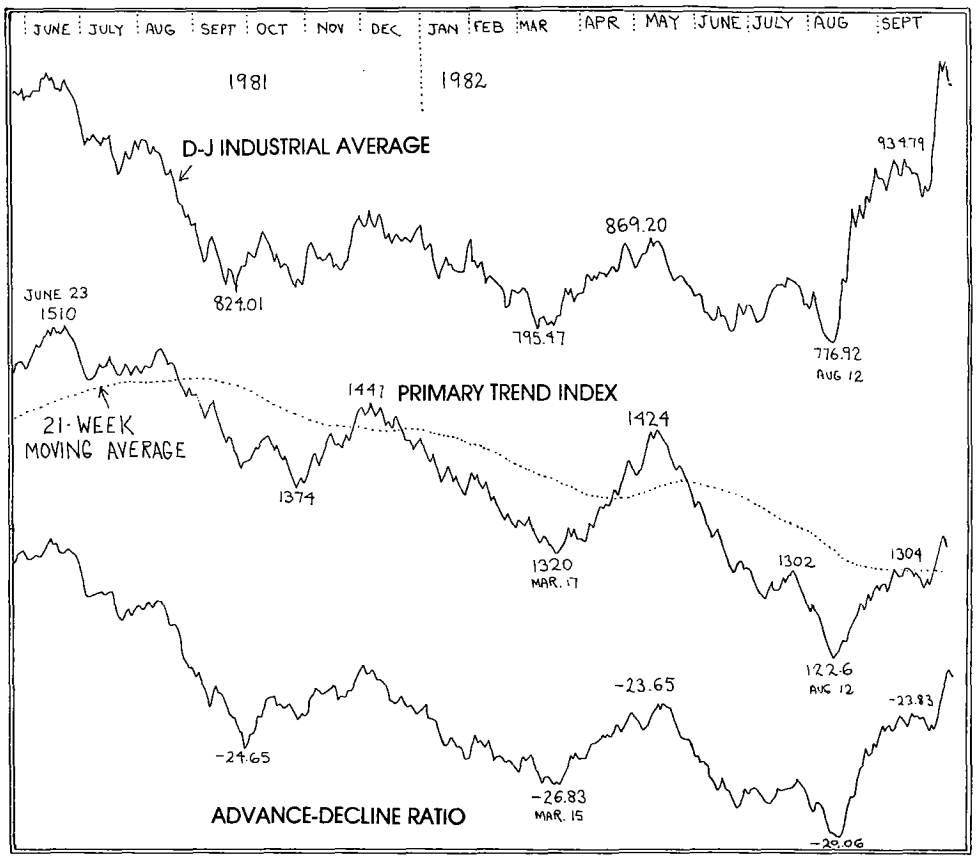
Answer: I hate to come in late on a move and lose money. Such stupidity throws you off balance, hits you in the pocketbook, and causes you to start doubting yourself. We do know a few things. First, the PTI has now formed a pretty impressive head-and-shoulders bottom, and I trust the PTI. The formation on the point & figure chart is such that I'd be surprised if the PTI went to a new low anytime soon. Thus, the August 12 low looks like a low that is going to hold for quite a while. That's a big plus.

On the negative side, if we study the history of the Averages we note that bull markets that move up very far and very fast tend to be short lived bull markets. Take an example, the bull market that began in July, 1932 (that bull market started from probably the most sold-out bottom in history). The Dow advanced from 41 to 80 in a period of only two incredible months (literally a double in two months!). But by February, 1933 the Dow had corrected back to 50.16. The Dow thereby wiped out better than 75% of its early bull market gains. Following this correction the market went on to its 1937 high (Dow 194). But the initial market explosion was, nevertheless, subject to a severe later correction.

My feeling is that regardless of whether this 1982 advance is a mighty bear market rally or an initial advance in a bull market, it is dangerous to buy here. I base this on the probability of a full correction of this rise somewhere in the period ahead. In 1933 the correction started two months after the bottom. We're just a bit past there now in the 1982 explosion.

Question: Suppose this market stays strong and refuses to correct?

Answer: In that case we'll be seeing a bit of stock market history. Every move in the past has been subject to correction, and the corrections are usually 1/3 to 2/3 of the previous uncorrected movement. Furthermore, the steeper and more violent the



rise, generally the more severe (or extended) the ultimate correction.

OPINION: *Question:* Russell, what do you see in the period ahead, and why?

Answer: As interest rates tumble, as the dollar finally weakens, gold is beginning to move–and the direction is UP. Let's face it, what we're looking at is a profound change in Fed policy. The Fed is back to controlling interest rates, and the money supply can go where it wants. This fact has not been lost on gold, and as the new gold bull market heats up, fears of inflation are going to rise again (despite the pious protestations of the Fed). I would say that if gold breaks above 510 (spot) to a new high for the move, you're going to begin to see pressure on the money market again (as it shrinks from a coming inflationary environment).

Remember, each cycle since 1945 has required more bank credit (and inflation) to "get the economy going again." This time I feel it will take literally new highs in inflation and credit infusions to really turn the economy around. Will the Fed be willing to deal with that kind of situation? Probably not. Thus, the economy is moving into a Catch 22 situation. There's no easy way out. It's a case of inflate or die, but the Fed is trying for something new–they're trying to guide us into the neutral zone midway between inflation and deflation. The policy is giving us some of the most violent markets in modern history.

Question: OK, so the game has changed. What do you see developing from here?

Answer: I think there's going to be disappointment as far as business's response and the consumer's response to lower interest rates. I think it could take two or three years for business to reliquify and for the consumer to get back into a big buying mood.

But I think the market is telling us that we've *passed the peak of fear.* For instance, as far as the collapse of the banking system, the bank stocks (which have rallied smartly) are saying that it isn't going to happen. The various nations that can't pay interest on their debts may be basket cases, but it seems the Fed is willing to hold up the baskets. What it means is there's no such thing as default or bankruptcy any more. In its place we have non-performing loans, re-scheduling, creative bookkeeping. All this will work for a while, maybe for years. The market has told us that the emergency is being held in abeyance. The world will survive the rest of 1982 and well into 1983.

Question: What do you see for the stock market in the period ahead?

Answer: My *guess* is that we are not starting a major bull market at this time. If we go back in history, we can see that when the market roared off its lows (as this market did in mid-August usually the greatest part of the rise was over in a period of a few months.) On the other hand, when the market moved off major bear market lows in a gradual manner, those are the times when great bull markets were probable. Slow gradual rises were seen off bottoms as 1921, 1942 and 1949.

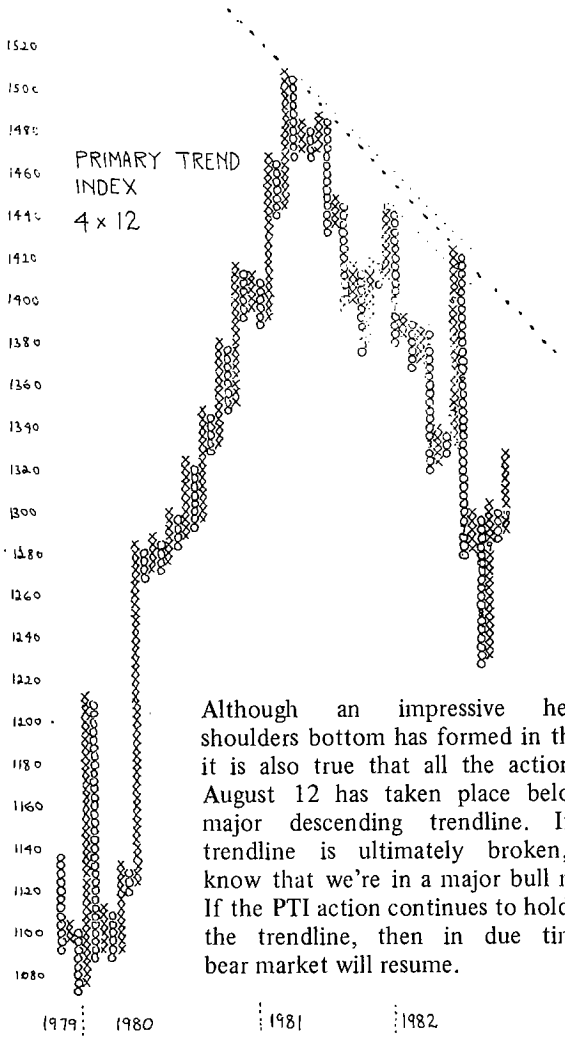
What I do envision here is more of a trading range market with the Dow probably pushing near or perhaps a bit above its all-time highs (around 1050) and then perhaps probing the lower 800s again. This frustrating kind of pattern could go on for years or until the economy has worked out some kind of solution for its massive debts.

Remember, the basic problem in the US (and throughout the world) is the intensifying clash between the forces of inflation and deflation. The forces of deflation are ever-present because of the cost of servicing the huge debt structure which has been built up since World War 11. The forces of inflation are ever present because (1) politicians hold their jobs by giving the people government handouts, and (2) because there is a natural tendency on the part of governments to handle their huge debt loads via the inflation route.

As I've stated so many times, when two opposing forces become stronger and stronger, the conditions are ripe for violence. That violence is expressed today through explosive market swings, spikes in the charts, sudden whips in interest rates, wild moves in precious metals and commodities.

Question: Russell, what effect does all this have on your investment philosophy?

Answer: I feel more strongly than ever that the key to surviving is emphasis on preservation of capital. When you trade today, you are chasing soft dollars (profits subject to taxation) with hard dollars (dollars that remain after taxes). Thus a person makes $100,000 and is left with say $50,000 after taxes. He uses



Although an impressive head-and shoulders bottom has formed in the PTI, it is also true that all the action since August 12 has taken place below the major descending trendline. If that trendline is ultimately broken, we'll know that we're in a major bull market. If the PTI action continues to hold below the trendline, then in due time the bear market will resume.

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those after-tax hard dollars to trade the market. If he wins, he makes perhaps $10,000. Those profits are subject to additional taxes. If he loses, then the $50,000 that he had left after making $100,000 is reduced further–to say $40,000. Thus, the mathematics of beating the market is very discouraging today. And the important thing is to *avoid losses of hard, after-tax dollars.* This is one of the most difficult concepts to get over to subscribers.

Question: So what's the answer?

Answer: In my opinion, this is the answer: you tend to stay pretty much in good-yielding debt securities. This eliminates the possibility of loss of principal, especially if you stay in debt securities with maturities of five years or less. In this way, even if you buy incorrectly you simply wait until your debt vehicles mature and collect your money.

But aside from safe investing in interest-bearing securities, I try to invest with the primary moves in the markets (if I'm smart enough or lucky enough to catch them). And here one market is as good as the next. So far, we did catch the gold move and the recommendations (gold coins, ASA, Campbell Red Lake) turned out profitably.

As for the stock market, so far in this cycle I haven't been sure enough of what's going on to say "buy." But the story isn't over yet, and the market is always there. Also, it's well to remember that there is a vast difference between missing a move and going broke during a move (as those who are short this market have been finding out). At any rate, my basic market philosophy these days entails preservation of capital, compounding your capital via attractive interest rates, AVOIDING major losses at all times, and trying to catch important moves where possible.

I might add that ignorance of this kind of thinking is one reason why so many investment advisors fail. They simply don't understand the basic fundamentals of handling money. They concentrate on beating or out-trading the various markets. They make a few good calls and a few profitable trades. But sooner or later they "kill" their subscribers with a costly bad play. The result is the great disillusionment. And alas, the service goes down and out.

PRIMARY TREND INDEX: In a primary sense my PTI has not confirmed the Dow. I say this because the PTI is currently far below its May peak of 1424, while the Dow is way above its own May peak of 816.88. Nevertheless, as you can see on the page 3 chart the PTI is in a *decided rising trend.* The daily chart shows the PTI pushing above both the July peak of 1302 and the September peak of 1304. The PTI has also rallied decisively above its 21-week moving average. So the trend is bullish for the PTI. A trendline connecting the August and October lows indicates that the PTI would have to break below 1300 to turn bearish again.

The same can be said of the advance-decline ratio, except that the A-D has now bettered its May peak by a wide margin. Why the PTI has lagged so far behind the Dow, the major averages and the A-D ratio I do not know, but there may be a message in this somewhere down the line. Perhaps the PTI is telling us that there is some technical flaw in this market rise, a flaw that is not apparent except to the PTI.

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The point & figure chart of the PTI offers real food for thought (chart page 4). If you remember, it was the pronounced top in the PTI as seen on this chart which was instrumental in turning me bearish in 1981. Now we see the opposite effect.

The chart covers four years of action in the PTI. Note that the 1981-82 bear market took the PTI down to the 1228 box, and 1228 was just above the 1979 peak in the PTI at 1212. Thus, the bear market in the PTI met support at the 1979 high.

But it is the recent structure which I think is important. From its 1982 low of 1228, the PTI has now formed a head-and-shoulders bottom. The upside breakout from the head-and-shoulders bottom came just a week ago when the PTI touched the 1308 box. The head-and-shoulders bottom could have enough power "stored within it" to take the PTI to a test of its last peak at 1424.

Conclusion:The great value of the PTI is that it sums up in a single indicator all the various forces and nuances that go to make up the trend of the market. One characteristic of the PTI is that it seems to form head-and-shoulders patterns at tops and bottoms in the market. The PTI formed a H & S top in 1981. Now it has formed a H & S bottom. The PTI is now in a bull trend. And the bottom formation appears to be one that will hold for quite a while.

INVESTMENT POSITION: I've pulled the bear out of this box. I've removed him on the basis of the pattern in the PTI. Does that mean I'm bullish on the stock market? Well, it means that I'm ready to be convinced either way. But I won't fight my PTI, and the fact is that the PTI has formed a head-and-shoulders bottom.

Since the August 12 low of 776.92 in the Dow, there's been only a single 7-day decline. That's hardly enough to take the steam out of the market boiler. Therefore, I think doing anything here is basically dangerous. If this is fated to be a big bull market, then we'll have ample opportunity to buy. If the bear still lives, we'll know it by year's end. Classically, the safest time to buy in a new bull market is near the bottom of the first correction in the new bull. There's been no correction so far. So I'm waiting.

Meanwhile, my gold advice was all right. I recommended gold coins plus only two gold stocks, Campbell Red Lake and ASA. Average appreciation on the two stocks since the recommendation is now 60%, twice that of the Dow. Continue to hold gold up to 15% of total assets. I don't think the Democrats or the Republicans can turn this economy around without resorting to–inflation. And gold knows it.

As far as money instruments, continue to hold 75% of your liquid commitments in T-bills, 25% in 5-10 year T-notes.

NOTES & QUOTES: Walk or Ride? Ford and Chrysler are expected to show third quarter losses. But Nike, famous for running shoes, will report a third quarter profit about 45% above last year. Jog, don't ride, seems to be the word for today.

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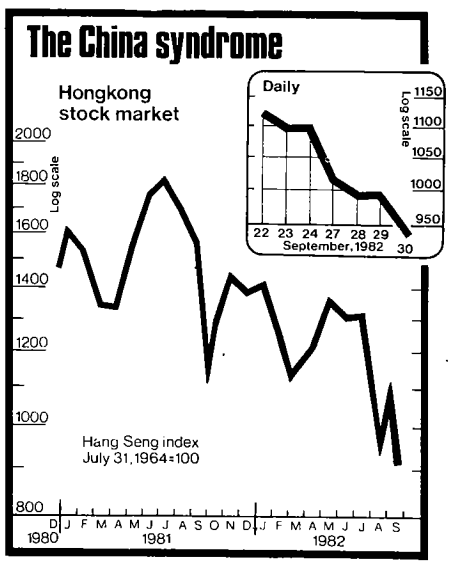
Crash: The wonder-economy and stock market of recent years has been Hong Kong. But lately, the Hong Kong real estate market has tumbled and the Hong Kong stock market has entered its own version of 1929. The fear: Hong Kong's lease from China runs out in 1997, and the word is that China may not renew. The chart (from the London Economist) shows the Hong Kong market losing half its value following its mid-1981 high.



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One advisory service that takes the same jaundiced view of debt and illiquidity that I do is Weiss Research In. Box 2923, West Palm Beach, Fla 33402. This is an excerpt from their latest issue of "Money & Markets": "Bankers are still struggling to cover up and refloat bad loans; the Treasury is still adding aggressively to its mountain of debt ($27 billion in the second quarter of 1982 alone against $10.6 last year). And municipal governments have stepped up their pace of borrowing in 1982 over 1981 by 90%. All in all, total new debts created in the second quarter came to $121 billion or an annual rate of $484 billion."

This massive and growing debt structure means that there can be no important contraction of business without widespread bankruptcies and a liquidity crisis. Why? Because it takes rising business and inflation to support a giant debt structure such as we have in the US. Even now, as the economy mills about in recession, illiquidity builds and bankruptcies mount. As a matter of fact, bankruptcies in the US are now higher than any year since the Great Depression. So far, the trouble is mostly confined to the heavy industry sectors of the economy. But the *Holt Advisory* of Westport Conn. in its latest report makes the case for a slump in the service industry coming next.

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One of the things I stress is steadiness in investing, resisting too much trading, staying with intelligent positions. The record of the top 15 investment advisors (they manage money) during the first nine months of 1982 is instructive. Here it is, as published by Computer Directions. Note that for the nine months most of the advisors would have done just as well if they had stayed 100% in T-bills.

The top 15 investment advisers were:

	3rd Qtr.	Nine Months 1982
Brokaw Capital Management	18.3%	8.6%
Rollert & Sullivan	17.9%	8.1%
Provident Investment Counsel	17.9%	10.7%
Penmark Investments Inc	17.7%	6.1%
Ruane, Cunniff & Co.	16.3%	21.9%
Glickenhaus	16.1%	–6.7%
Martin Sosnoff Assoc	16.0%	N.A.
Institutional Capital Co	15.6%	11.5%
Mackay-Shields Financial	15.6%	–2.3%
Schafer Capital Management	15.2%	10.5%
Atlanta Capital Corp	15.1%	16.2%
Rothschild Co	15.0%	2.0%
Quest Advisory Corp	14.9%	8.3%
Miller, Anderson & Sherrerd	14.8%	9.8%
Lincoln Capital Management	14.7%	9.0%

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Do you know what the three big lies of 1982 are?

(1) Oh that, that's just a cold sore.

(2) Of course my BMW's paid for.

(3) I'm from the Senate Finance Committee, and I specialize in tax fairness and compliance.

* *

What are the stars worth in terms of Wall Street? I honestly don't know. But I've been following Arch Crawford's "Crawford Perspectives" for some years, and he has a good record. And yes, Arch uses interplanetary and star and sun and moon calculations to arrive at many of his remarkable forecasts.

His forecast in his latest report particularly interests me. It interests me because his forecast jibes with the bottoming of my 233-day stock market cycle. My cycle is due to hit its low around the first week in November. Arch writes: "Considering that a 179 year cycle bottoms on or about November 1 and a 33.4 year cycle does likewise on November 7-8, we are, for a few weeks at least, throwing our hat in with 'Dr. Doom and Dr. Death'." Again he says, "Our worst case scenario must unfold between October 23 and November 8th." At that time, Crawford thinks that "anything that can go wrong, will; and, they'll all happen at the same time." So let's watch and wait. (Crawford, 250 E. 77th St. NYC 10021)

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From our "Famous Quotes of 1982" Dept.

> **Lamar Hunt,** Kansas City Chiefs owner and American Football League founder, had this to say in a speech at Buffalo: "Where was Ed Garvey and some certain people 23 years ago? I don't remember him coming forward to take on 55% of the losses in the early days."
>
> Hunt, claiming that lawyers and contracts are killing football, said: "Let me say this. The best description I know for an utter waste would be for a busload of lawyers to go over a cliff with three empty seats."

* *

The news is beginning to leak out. Get ready for the $175 billion deficit in 1983. That's $3.3 billion a week in deficits for fiscal 1983. And as for our running total of US debt, the latest figures show that the debt is now $1.132 trillion and moving up fast. Under these conditions, in my humble opinion, there's no way that interest rates can stay down.

WASHINGTON — President Reagan will be confronted by another huge budget deficit in 1984 — possibly as large as $175 billion — if the economy remains sluggish and he sticks with his present policies, according to an internal White House staff projection.

The White House, embarrassed by the unauthorized leak of the projection just three weeks before the Nov. 2 congressional elections, refused to comment on the report and declared a "moratorium" on talking about budget leaks until the official spending plan for fiscal 1984 — which begins on Oct. 1 next year — in January.

Government Finances

WASHINGTON (AP) – Here are figures on government spending and debt (last six digits are omitted). The government's fiscal year runs from Oct. 1 through Sept. 30.

Total public debt October 7	1,132,505
Interest on public debt Aug	9,476
Interest fiscal year thru Aug	108,344
Projected deficit fiscal 1982	108,884
Projected deficit fiscal 1983	115,018
Actual deficit fiscal 1981	57,932
Receipts fiscal year thru Aug	558,072
Receipts period last year	538,993
Outlays fiscal year thru Aug	667,021
Outlays period last year	603,260
Gold for Aug	11,148

WASHINGTON, Oct. 14 — Former Defense Secretary James R. Schlesinger predicted today that the Federal deficit would exceed $200 billion in 1984 and that the ensuing political pressures would drive military spending below the amount planned by President Carter.

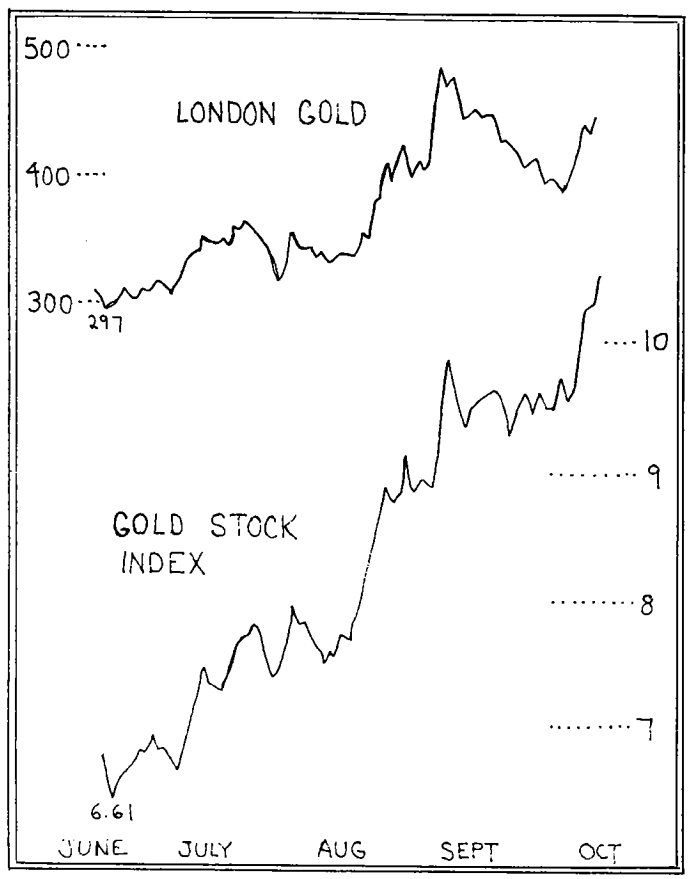
Mr. Schlesinger, who is an economist, told a gathering of military industry executives that the national consensus on rebuilding the armed forces had "evaporated." He asserted, "The United States as a nation is not prepared to provide the resources to match the Soviet Union."

GOLD: Like all the markets today, gold is a nervous market. One of the best ways of staying calm when markets are suffering the jumps and jitters–is to watch the moving average. The 50-week MA for gold is creeping up at the rate of 2-4 points a week; it now stands at 388. The 13-week MA for gold just pushed above 400, at 403. And the 5-week sensitive MA for gold is now 423. So from the standpoint of the moving average studies, gold above 423 looks fine.

My daily chart shows gold advancing from June's low of 297 to a 1982 high of about 488. That's a rise of 65%, a whopping three month rise by any calculation. Since September, however, the gold stock index has been outperforming the bullion. On a total bull market basis, the gold average has risen from a June low of 6.61 to a recent high of 10.50, a rise of about 59%.

I continue to feel that the gold market is a simple one to play. I like Campbell Red Lake and ASA (both on the NYSE), plus a generous quantity of maple leafs or krugerrands. With gold, I feel the thing is to "keep it simple."

Again, I remind subscribers not to take positions that are too large. "What's too large?" you ask. A too large position is one that keeps you up nights when the item goes against you for a few days. A too large position will shake you out every time. I've seen dozens of investors buy "over their heads," get knocked out on the first reaction, and then watch their item take off into the blue yonder. Buy gold (or stock or bonds or anything else) according to how that position affects your stomach. If your guts recoil, you're buying too much, you're overboard. It's as simple as that.



NEXT MAILING: November 3